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"The length and severity of depressions depend partly on the magnitude of the 'real' maladjustments which developed during the preceding boom and partly on aggravating monetary and credit factors — the scramble for liquidity, destruction of bank money, and similar events on the international level."

Prosperity and Depression, Gottfried Haberler, p. 470
George Allen and Unwin Ltd., London, 1937

HIGHLIGHTS

International economic conditions have deteriorated dramatically across a broad front, while unexpectedly, inflation is proving rather resistant in most countries.

In theory, the only avenue for economic recovery in the high-consumption countries is through an export boom. With slowing world growth that's not likely. What looks like a solid and convincing export boom in the United States is mostly a statistical fiction.

Even though the U.S. economy may be groaning under tight liquidity and credit, Wall Street seems to have decoupled from the real economy and the constraints of weak money growth. Does there necessarily need to be a close financial-market connection with the activity in the real economy?

Miserable trends in consumer income, employment and business profits show the real causes of the sharp economic downturn. The income decline is the sharpest of the entire post-war period.

Since the U.S. corporate sector finds itself mired in a condition of record illiquidity, record overindebtedness and during a secular low point in profitability, employment rolls are suffering much more violently and earlier than during any other post-war recession.

The simple fact in all Anglo-Saxon countries is that a credit deadlock was inevitable even without a monetary tightening. The bursting of the debt bubble has arrived with a vengeance.

If the public desires to become more liquid, only the banking system can permit it to do so. But when a banking system has completely stopped its net new lending and investing activities it becomes virtually impossible. Exactly that is now happening in the United States.

Despite an apparently easy reserve stance, why have banks also stopped purchasing government bonds which pose no credit risk at all? What has caused this collapse of the monetary machinery?

For the first time since the 1930s, the Fed is indeed "pushing on a string". This is a complete credit deadlock which is in the same league as the credit blockage of the 1930s. The inevitable conclusion is that the credit system is no longer under the Fed's control.

The statistics concerning the real economy plainly show that the U.S. recession — and that's also true for some other deficit countries — is deepening. Given the monetary deadlock, we have become more pessimistic than ever about the U.S. economy, its financial markets, and its currency.

DESPERATELY SEEKING RECOVERY

In recent months, economic conditions have deteriorated dramatically in most corners of the world. Industrial production has fallen below year-ago levels in eight out of 13 major industrial countries. Everywhere the decline is broad-based, hitting consumption, construction and investment. Meanwhile, rather unexpectedly, inflation is proving rather resistant in most countries.

Considering the near-euphoria in the stock markets, it may be appropriate to start this letter with a brief synopsis of global economic trends. Two key indicators are compared in the following table.

INTERNATIONAL ECONOMIC TRENDS

	INDUSTRIAL PRODUCTION		CONSUMER PRICES	
	3 mths.*	1 year	3 mths.*	1 year
United States	-10.8	-0.9	+4.5	+5.7
Britain	-6.1	-4.2	+2.5	+9.0
Canada	-9.7	-5.1	+5.8	+5.0
Australia	-10.5	-1.7	+11.2	+6.9
France	-10.4	-1.4	+3.9	+3.3
Italy	-5.2	-3.4	+7.8	+6.5
Spain	-4.5	-0.6	+5.7	+6.7
Germany	+4.1	+5.7	+2.1	+2.9
Japan	+7.1	+6.0	+7.3	+3.8

* At annual rates.

Source: The Economist, Economic and Financial Indicators.

Supposedly, far-seeing markets — particularly Wall Street — have their own logic. While the declines in consumer confidence, business profits, employment and production in the Anglo-Saxon countries have been simply earth-shattering Wall Street sees reasons to celebrate. There, the stock market advance from the October lows has already been the fifth strongest on record since the 1930s. In classic bull-minded fashion, the majority of investors are brushing aside bad news about falling earnings, the real estate slump, a banking crisis, and credit crunches. And where Wall Street leads, most other markets follow.

The dreary economic outlook when compared with the present market euphoria seems paradoxical, if not perverse. Yet, when seen in the light of past cyclical experience, the market upswing is logical when based on two key, consensus assumptions. The only snag is that the first key assumption concerning the economy rests on nothing more than wishful thinking: that the U.S recession will be short and shallow — bad news will therefore be distant memory by the end of the summer. The second assumption, that the excess money being pumped into the economy by the Fed invariably tends to buoy bond and stock markets well before assuredly simulating the economy may be suspect, too.

Seeing the bull stampede, we cannot help but be reminded of a biting remark made by Keynes: "*Men, like dogs, are too easily conditioned that, when the bell rings, they will have the same experience as the last time.*"

Clearly, Wall Street hears a bell . . . a clarion toll supposedly signalling that this unexpected recession will end in the usual way, in the usual time, despite the unique circumstances under which it started.

At issue, of course, is whether the presently unfolding U.S. recession will be unusually deep or short. The start was certainly unconventional enough. There wasn't any smoke of overheating, nor excessive inventories nor an inverted yield curve. In fact, the opposites prevailed: rock-bottom inventories and short-term rates that had been falling for a year and a half.

But, rather than being disturbed by these incongruities, Wall Street and Company quickly seized upon a convenient and comforting scapegoat: Saddam Hussein and the Gulf War, triggering an unforeseeable collapse in consumer confidence. From this perspective, the War's end must logically then mean a quick end to the recession.

Durable market rallies, though, need more than just bullish expectations. They also need sufficient pecuniary fuel: money. While the economy may be groaning under tight liquidity and credit, Wall Street seems to have decoupled from the real economy and the constraints of weak money growth. How is this liquidity lag possible?

FINANCIAL OVER-LIQUIDITY AND CORPORATE ILLIQUIDITY

An obvious and substantial reason for this decoupling of Wall Street — meaning the existing pools of funds mainly dealing in financial instruments — is attributable to the lingering effects of the past takeover and corporate stock repurchase boom. Vast amounts of cash were injected into this "financial circulation" (an expression of Keynes), flooding America's financial community with $500-600 billion in cash over the past five to six years. Even as recently as last year, corporations were the biggest buyers of U.S. shares at an annual rate of about $80 billion, comparing to purchases of $147 billion in 1989.

Due to these huge cash injections from the corporate sector — both past and present — Wall Street may well be able to lead a life of its own for a while and bull ahead even against an adverse economic background. There doesn't necessarily need to be a close connection with the activity in the real economy. Perversely, Wall Street's astounding liquidity originates directly in the corporate sector's illiquidity . . . a mirror image so to speak.

Still, there is an incredible contradiction within the pat psychological explanations that are popularly cited to substantiate recent economic and financial events. Just how can it be possible that the real economy plunges because consumer confidence collapses, on the one hand, while at the same time a booming stock market anticipates economic recovery? Our presumption is that there must be two different groups of people.

The cheerful players on Wall Street, those being the stock-owners apart from institutions, are the richer Americans. They are the smaller creditor class of the population (governing the financial circulation) and bask in record-high dividend and interest income. Interest income as a percentage of overall personal income in the U.S. has climbed to all time highs reflecting, among other things, increasing indebtedness.

The doom and gloom which shows up in the plunging consumer confidence indexes, by and large, reflects the mood and dreary situation among the much broader debtor class. Their fortunes depend more directly on employment incomes emanating from the ailing industrial and commercial circulation. This class is being progressively squeezed by high debts, falling real income and sinking home equity — their main component of net worth — as home prices fall. The incessant demands of compounding interest saps liquidity away from this group — a group, incidentally, that has a high propensity to spend and consume — and adds to the financial liquidity of the creditor class and captive savings pools.

AN INCOME DOWNTURN GATHERS MOMENTUM

For months now we have stressed a consistent theme in these letters that the cause of the collapse in consumer confidence is not found facing the East. Something much more tangible than quixotic psychology has been at work here. A look at the miserable trends in consumer income, employment and business profits shows the unmistakable causes of this sharp economic downturn.

After starting only slowly, a downturn in income has gathered momentum recently. In the United States, real disposable personal income stopped growing as early as last year and went into a tailspin last October. Between July 1990 and January 1991, real income has declined from $2,910 trillion to $2,854 trillion, or $56 billion, and real spending has fallen from $2,695 trillion to $2,653 trillion, or $42 billion (all figures taken at annual rates). What's apparent here is that income losses have even exceeded the spending decline.

Such a sharp and persistent downturn in incomes has never happened before in the post-war period. After experiencing losses in the third and fourth quarter, the recently published figures for January showed the worst income decline ever. But neither Wall Street nor most of the media took any notice. In our view, the income and employment figures are the clues to focus on during this recession.

U.S. REAL CONSUMER INCOME AND OUTLAY
(Seasonally Adjusted, Annual Rates, $ Billions)

	Income	Outlay
Second Quarter, 1990	2,900	2,678
July 1990	2,910	2,695
August 1990	2,896	2,696
September 1990	2,886	2,698
October 1990	2,864	2,673
November 1990	2,867	2,670
December 1990	2,281	2,682
January 1991	2,854	2,653

As we took pains to point out in the February letter, in this economic downturn there is a tight linkage between personal incomes and corporate profitability trends. Since the U.S. corporate sector finds itself mired in a condition of record illiquidity, record overindebtedness and during a secular low point in profitability, employment rolls are suffering much more violently and earlier than during any other post-war recession.

All these elements we mention should be eminently clear to any economic layman. Yet, there seems

to be a virtual conspiracy in ignoring these crucial economic factors. Instead, as we already reviewed, everybody, including the Administration and the Fed, happily clings to the more convenient belief that the Gulf War must have engendered a temporary confidence crisis which, of course, leads to the even more likable conclusion that the war's end will restore confidence and prompt a burst of consumer spending. Just what is going to fund this new spending spree? Will falling incomes provide the fuel or will it be the next borrowing binge? Who bothers about such minor details, anyway?

THE CRUCIAL DIFFERENCES IN THIS RECESSION

Every recession can be traced to the excesses and maladjustments which developed during the preceding boom. The recession, then, is the period in which the economy absorbs these distortions. Any assessment of an unfolding recession, therefore, has to start with an assessment of the specific excesses and maladjustments that have accumulated during the boom.

Ever since 1945, business cycles were mainly inventory fluctuations. Just as inventory fluctuations governed the movements of the real economy, they also determined the pro-cyclical behaviour of money, credit and interest rates during booms and recessions.

Recessions occurred because businesses liquidated their excess inventories, and in so doing, reliquefied and rebuilt their strained balance sheets. This process of reliquefication played a key role in setting the base for the future recovery.

In general, it has been taken for granted that it was mainly the monetary easing that ended past recessions. While monetary ease was undoubtedly important, it has to be realized that inventory fluctuations are fundamentally a short-term phenomenon. The liquidation of excess inventories played out in less than a year; therefore that being the average duration of postwar recessions. Once the liquidation had run its course, production automatically snapped back, leading the recovery, even though final demand may not have changed. The key point to see is that this type of liquidation is self-limiting.

UNSUSTAINABLE CONSUMPTION

In the last letter, in particular, we detailed the main structural distortions which built up in the Anglo-Saxon economies during the course of the last boom. The key characteristics we identified encompassed a grossly disproportionate rise in consumption, on the one hand, and substantial deformations in the investment structures — including large malinvestments — on the other.

In all of these countries — Australia, Britain, Canada and the United States — the recent boom was consumer-led. In itself, that's nothing new for these countries. But what is unprecedented in the postwar period, is the sharp increase of consumption as a share of GNP and its propellant: an unprecedented consumer debt-bubble fuelled and collateralized by booming property values.

This development had many attendant aspects. The most astonishing of these, however, was the widespread perception that such borrowing binges can go on forever. In the United States, between

1982-89, the value of consumers' houses increased by approximately $1.3 trillion but so did the value of mortgages outstanding. Overwhelmingly, home equity loans helped finance a boom in current consumption.

The simple fact is that in all Anglo-Saxon countries such borrowing binges (lasting seven and eight years) have inflated consumer spending to unsustainable levels. Sooner or later, the inevitable credit deadlock was destined to arrive even in the absence of monetary tightness. Without a doubt, the bursting of the debt bubble has arrived with a vengeance.

The consumer is being squeezed financially from all sides. Falling employment coincides with falling property values thus curbing current income and reducing wealth. For the United States, this is the first absolute decline in household wealth since the 1961-62 recession while for Britain, it is the first decline since 1974. Rising property prices played a key role in the upswings. Now, falling property prices play a key role in depressing consumer spending.

THE UNSTOPPABLE DOMINO EFFECTS

Essentially, consumer spending has to adjust to a lower level that's more in line with the development of current incomes. As alluded to earlier, incomes are falling as businesses faced with sliding profits are trimming their payrolls.

One may well ask oneself why there is such a cascade of adverse influences all so suddenly. That's just how cumulative and self-reinforcing downturns tend to work. Consumption falls because employment falls; construction falls because there has been gross overbuilding; business investment falls because profits collapse; and inventories are cut because sales fall. Wages, profits and sales plunge because consumption and investment plunge, and vice versa. All these movements are naturally interlocked.

What can the consumer do, and how will their response impact the economies? So far, the American consumer has drawn on his savings to cushion his living standard from the income drain. But, with a savings rate of 4% — already near a record low — there is little to draw on. What would happen if the consumer finally capitulates and decides to boost savings? The prospect of that happening is becoming the nightmare of some forecasters.

Interestingly, that is just what is happening in Britain. The country, too, has caught a severe case of a consumer-led recession but one that is somewhat different than in the United States. Britain's recession finds its cause in sharply lower borrowings — not in falling incomes — which therefore translates into higher savings. Britain's property crisis is rather worse than its American counterpart. Meanwhile, real disposable income growth, too, is decelerating sharply as businesses slash employment.

Construction in all the Anglo-Saxon countries, given the glut of office and retail space, is already in its deepest crisis of the last ten years. At the same time, all signs point to weak, if not slumping business capital spending on structures and equipment. Above all, new orders for investment goods are falling everywhere at an alarming rate.

In the last analysis, all these high-consumption economies have three crucial long-term ailments in common: chronically poor profits coupled with a chronically poor productivity performance that results in a deep-rooted inflationary bias. As soon as production falters, these negatives strongly come to the forefront. To understand the U.S. profit squeeze, one has to realize that productivity growth disappeared three years ago. In fact, during the last two years, productivity has declined almost 2%. During these same three years, business productivity in Germany, for example, grew about 8%.

While the emotionalism of Wall Street and many other financial centres has already capitalized the certainty of an imminent economic recovery, any logical analysis of economic and financial realities leads to an opposing conclusion; that the present downturn continues to spread broadly and gathers momentum.

RECOVERY: WHAT WILL LEAD THE CHARGE?

In theory, the only avenue for economic recovery in the high-consumption countries is through the demand boost of an export boom. However, since most other economies are also losing steam, foreign demand for the goods of these deficit countries can be expected to weaken, not strengthen.

Yet, American economists remain convinced that the "cheap" dollar can't help but trigger an export-led recovery. Past experience argues otherwise, though. The predominant influence on trade flows are the changes in relative demand levels. That dynamic tends to eclipse the influence of any change in exchange rates or relative prices.

Speaking of Germany, whose import boom plays a great role in these considerations, it may be mentioned that German goods imports from the United States amounted to barely DM 37 billion last year, down slightly from DM 38.3 billion in 1989. Imports from the U.S declined in a year in which overall German imports rose by 10%.

Actually, during 1990, U.S. merchandise exports have been virtually flat, stagnating at around a $96 billion level each quarter. Only the fourth quarter showed a modest increase to $102.7 billion, a spurt which may well have been attributable to the Gulf war. In the meantime, however, demand growth in the rest of the world — particularly so in the more important U.S export markets such as Canada and Britain — continues to decelerate.

Admittedly, these developments are in flagrant contrast to the general perception that the United States is enjoying an export boom. However, this astonishing contradiction between opinion and fact has an obvious reason. Unfortunately, most economists seem not to understand the statistics, or either, they only read what they want to read.

EXPORT BOOM: A STATISTICAL MIRAGE

The main evidence that is cited as proof of an ongoing U.S. export boom is the drastic improvement in real net exports in the GNP account for the fourth quarter of 1990. After two quarters of negative growth, net exports gained $22.9 billion, slashing the real net export deficit to $23.6 billion from

$46.5 billion in the quarter before. To be sure, that looks like a solid and convincing export boom. Yet, it's mostly a statistical fiction.

Adding to the misconception, these GNP figures have also created the fiction of a continuation in strong final demand. In its recent report on the fourth quarter, the U.S. Department of Commerce (USDC) expressly states that the GNP decline of 2% was centred in inventory liquidation and decreasing motor vehicle output and that final demand practically remained flat having declined only a minuscule 0.1%. No wonder this report cheered Wall Street.

In reality, the USDC commentary is an unbelievable distortion of the truth. The more objective interpretation is that domestic final demand (excluding government spending) fell right across the board. Consumption fell 3.1%, nonresidential investment 4.6%, and residential investment 15.4%; altogether accounting for an absolute decline of $34.2 billion. It's only when such a sharp decline in demand is white-washed by a gain in net exports of $22.9 billion and a 9.8% increase in government spending that one can come up with Washington's and Wall Street's twisted conclusion that final demand looks rosy and that everything is fine with the U.S. economy.

Let's, return to the dubious net export figures. First of all, before we probe any deeper, one should always bear in mind that these GNP data are annualized, meaning that small erratic movements are tremendously magnified. Second, these figures include services and factor incomes. The falling dollar translates into higher incomes from abroad, which, it should be noted, statistically enhances U.S. GNP growth. But the most important point to consider is that the improvement in net exports for the fourth quarter consisted of two dynamics: an annualized rise in exports of $11.9 and an annualized decline in U.S. imports of $11 billion.

What happens in the GNP statistics is that any excess of imports over exports is subtracted from gross domestic product since that part of current consumption or investment has been produced abroad. However, this statistical methodology misleadingly implies that falling imports add to U.S. GNP and final sales. They do not.

In order to measure the true stimulus of net trade improvements, net exports should be adjusted to remove the portion of import decline that reflects shrinking domestic demand. In any case, without annualizing the figure, merchandise exports rose $6 billion (nominal) over the previous quarter.

MORE STATISTICAL MYTHOLOGY

Speaking of statistical shenanigans, even more bizarre is the impact of changing import prices on the GNP account. It concerns the price deflator for GNP. The fact that the GNP decline was smaller than expected in fourth quarter (2% versus an expected 3%) was mainly due to the ominous decline in the "implicit GNP price deflator" from 4.7% in the second quarter to 2.8% in the fourth quarter. That decline in itself contributes a boost to real GNP growth of 2% for this period.

Looking at the individual component price indexes, however, one finds that they are all immensely higher than the GNP deflator. For example, the consumption deflator increased to an annualized rate of 7.1%, up from 5.2% in the preceding period. How then is it possible to report a record-low

deflator for the GNP account?

It may be hard to believe, but the reason that's possible is the statistical treatment of exploding import prices. Mainly due to soaring imported oil costs because of the Gulf crisis, the import price deflator shot up to 12.6% in the third quarter and to 28.1% in the fourth quarter (both taken at annual rates).

As explained, imports are accounted as a deduction in the GNP accounts, therefore falling imports act as a positive enhancement. In the same way, rising import prices are subtracted from the GNP price index. Hence, higher import prices mean a lower implicit price deflator for GNP. Paradoxically, the 0.5% of GNP constituting net exports has caused the total deflator to fall sharply, thereby boosting apparent GNP growth. This fractional tail of 0.5% wagged a big dog. Congratulations, if you can make sense of all this.

RECOVERY HALLUCINATIONS

Everybody nods to the notion that peace in the Middle East will now quickly initiate an economic recovery. This consensus belief is rather hard to argue with since it is so nebulous. Nobody bothers to explain the mechanics of who and what will power the recovery. Most seem happy to simply accept the idea of a "*resurgence in consumer confidence*". Apparently, even Mr. Greenspan is subscribing to this view giving notice that monetary policy will therefore remain on hold.

With consumer spirits renewed and attentions finally broken from the television coverage of the Gulf war, consumers are expected to rush back to shopping malls, automotive dealers and real estate brokers. And now that there is less talk of an export boom to Europe, there's all the more chatter of an export boom to Kuwait.

It is really touching to see how desperately all the faith-healers grab at any shred of news that may hint at a slowing of the downturn. Given the speedy decline of many economic indicators in recent months, there has to be a slowing in the downturn if we don't assume that the U.S. economy will vanish in a few months.

Leaving wishful thinking aside, the statistics concerning the real economy plainly show that the U.S. recession — and that's also true for some other countries — is deepening. If that is so, what about the monetary conditions and the monetary indicators?

MONETARY MYSTERIES

In his Humphrey-Hawkins testimony, Chairman Greenspan countered congressional criticism that the Fed had not eased enough with the argument that he saw evidence of accelerating money supply, which, in his view, warranted a pause in easing activities. Again, the reaction is typical given the prevailing attitude. After ignoring very weak money supply growth for years, the first sign of an acceleration is greeted as evidence of an effective easing.

To pull an economy out of recession, what's certainly needed is a sufficient monetary expansion. The definition of what's "sufficient" is always arguable, of course. But we know one thing for certain:

When a banking system has completely stopped its net new lending and investing, that is grossly insufficient. Exactly that is now happening in the United States.

Changes in the total supply of money come about primarily as a result of the lending and investing activities of the banking system in association with deposit creation. If the public desires to become more liquid, only the banking system can permit it to do so. Critics that argue that the credit generation of the banking system has been supplanted by non-banks (securitization and money market funds) overlook the fact that a monetary expansion (with all the attendant multiplier effects) is only possible through a fractional-reserve banking system.

Weakening private credit demand is normal in times of recession, as is presently the case. When this happens it always seems a remote possibility that lower interest rates will again restimulate borrowing. Indeed, it's that scepticism that often conjures up the perception that monetary policy might be "pushing on a string".

What these sceptics always overlook during this phase of the cycle is that the banking system tends to shift its expansion from lending to corporations and consumers to investment in government securities. The latter activity becomes the alternative channel through which the banking system expands the money supply during the recession.

Bearing that mechanism in mind, we have taken a closer look at the lending and investment activities of American banks over the course of the past year. At first, we didn't quite believe our eyes when we reviewed recent development. The following table showing the change of total outstanding loans and investments tells a shocking story. The figures represent the activities of all U.S. commercial banks and are seasonally adjusted at an annual rate.

The adjacent table reveals two disturbing features. The most important one is the persistent decline and year-end dive in new investments in government paper. The second unusual aspect is the continued expansion of illiquid real estate loans.

U.S. COMMERCIAL BANKS: LOANS AND INVESTMENTS, 1990

(Quarterly Changes, Billions of Dollars)

	Q1	Q2	Q3	Q4
Total Loans and Securities	187.2	135.2	156.4	45.2
U.S. Government Securities	104.7	64.8	34.4	2.4
Total Loans and Leases	85.2	79.2	116.0	58.8
Commercial and Industrial	11.2	28.8	0.0	11.6
Real Estate	82.8	73.2	58.4	58.0
Other Loans	-8.8	-22.8	57.6	-10.8

It may be that the real estate lending isn't exactly voluntary given the unfolding real estate crisis.

More recent monthly figures, reveal that these abnormalities are not getting any better. In fact, they're getting worse as the table on the next page details.

U.S. COMMERCIAL BANKS: TOTAL LOANS AND SECURITIES
(Seasonally Adjusted, Billions of Dollars)

	Oct.90	Nov.90	Dec.90	Jan.91
Loans and Securities	2,713.0	2,716.6	2,723.6	2,721.2
Govt. Securities	453.1	454.0	454.2	454.2
Other Securities	177.9	175.9	175.6	177.7
Loans and Leases	2,082.7	2,086.7	2,093.8	2,089.4
Real Estate	827.7	832.0	836.5	837.3
Individuals	379.7	378.7	378.9	375.9

As already explained, the normal pattern during recession is that banks confronted with weakening private credit demand, unload their excess liquidity on government securities which then leads the way to lower medium and longer-term interest rates.

Such purchases began promptly and heavily in late 1989 and early 1990. Ever since, though, these purchases have petered out rapidly and have since ground to a virtual standstill. Meanwhile, everybody, including Mr. Greenspan, explains the credit crunch and the weak money growth as being a function of overzealous and puritanical bank regulators that are arbitrarily restricting credit.

The allegations may be true, but that complaint misses the worst and most ominous part of the story. The crucial question of why the banks, despite an apparently easy reserve stance, have also stopped purchasing government bonds — which pose no credit risk at all — remains completely ignored.

In all his testimonials and speeches, Mr. Greenspan has never mentioned this crucial failure of his monetary easing, let alone even tried to explain it. It should have alarmed him long ago because it potentially heralds frightening prospects; firstly, for the financing of the exploding U.S. budget deficit at a time when foreign investors have taken leave of U.S. capital markets; and secondly, that this development excludes any possibility of a sustained money growth. For the first time since the 1930s, the Fed is indeed pushing on a string. This is a virtual credit collapse.

We are left with this question: What caused this collapse of the monetary machinery? We see three possibilities, all equally discomforting. First, given all the loan problems, the banks consider it prudent to keep a higher ratio of reserves than during more normal times; and second, they may be afraid of the interest rate risk. If, as the consensus thinks, the economic recovery is actually around the corner, then that would raise the risk of rising interest rates and falling bond prices.

The third reason, which we rank very high, could well be that due to flight into quality, the yields on government bonds may now be too low for the banks given their high refinancing costs and the stiff deposit-taking competition of booming money market funds.

SUMMARY CONCLUSIONS

The most important question for the time being concerns the widely anticipated U.S. recovery. As we have always emphasized, the recession was not brought on by the war. We must logically conclude that peace alone won't launch a recovery either.

In contrast to most others who fixate on the latest data, we focus on the deeper-seated causes of the current recession such as a profit squeeze, falling incomes, steepening debt ratios, record illiquidity, a property crisis and a credit crunch. As long as we don't see any underlying improvement in these fundamental depressants, recovery is impossible. That view, of course, also applies to Canada, Britain and Australia.

Actually, what we see is even worse than not seeing any recovery at all. So far we only observe worsening fundamentals. What's needed first of all, is a liquefication of the economy which only a banking system — no less an expanding banking system — can provide. That's not happening. The significance of the banking system is that it is the engine of credit creation and money growth.

What we now see in the banking figures, upon careful analysis, is more than just a credit crunch. It's a complete credit deadlock which is in the same league as the credit blockage of the 1930s. The crunch has already lasted too long to be regarded as an aberration.

The inevitable conclusion is that the credit system is no longer under the Fed's control. Having realized this, we have become even more pessimistic than ever about the U.S. economy, its financial markets, and its currency.

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